

Internal Revenue Service

memorandum

TL-N-3784-99

AMHarbutte

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to: Appeals Division
Attn: Appeals Officer Jerry Gossett, Laguna Niguel, CA
Appeals Officer Raul Pendas, Houston, TX

from: Alice M. Harbutte, Attorney
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subject: [REDACTED] Refund claims

Partners in certain [REDACTED]-sponsored partnerships have been filing claims for refund with respect to the year they disposed of their partnership interest. In addition to claiming a refund for the "basis adjustment" (the subject of a previous memorandum) these investors are also changing the character of the loss from capital to ordinary claiming an abandonment loss under I.R.C. § 165.

ISSUES

1. Whether the [REDACTED] partner is entitled to an ordinary abandonment loss under I.R.C. § 165(a).
2. Whether the issue concerning the existence of a sale/exchange vs. an abandonment of a partnership interest is an affected item.
3. Whether the partner timely raised the issue of abandonment in the claim for refund filed on [REDACTED]
4. Whether the partner in the present case has established sufficient facts to show that an abandonment occurred.

CONCLUSIONS

1. An abandonment loss is governed by I.R.C. § 165. Whether an abandonment of a partnership interest occurred is a question of fact. Even if abandonment is established, I.R.C. § 165(c) limits losses claimed by individuals to losses incurred in a trade or business, losses incurred in a transaction entered into for profit or losses arising from fire, storm, shipwreck, or other casualty or theft. The [REDACTED]-sponsored partnership are shams and had no economic substance, thus no loss is allowed under I.R.C. § 165. Even if the partner can establish that an abandonment occurred, and that it met the requirements of I.R.C. § 165(c), this does not automatically entitle the abandoning partner to ordinary loss treatment. If the abandoning partner was relieved of partnership liabilities capital loss treatment is required.

2. The ultimate issue of whether a disposition of a partnership interest is a sale/exchange or abandonment is an affected item. However, some of the facts that make up the individual elements involved in deciding whether an abandonment occurred may be partnership items and may not be redetermined in this claim for refund.

3. Affected item claims for refund must be filed prior to the expiration of the partnership statute of limitations under I.R.C. § 6229. The claim in the present case pertains to the [REDACTED] taxable year and was timely on [REDACTED].

4. The partner in this proceeding has not clearly established that an abandonment occurred. Partnership books and records must be produced to show how this transaction was treated by the partnership and whether the partner's share of partnership liabilities decreased as a result of the alleged abandonment.

FACTS

Adjustment to Basis as a Result of Appeals Settlement:

Numerous [REDACTED] partners filed refund claims with respect to the taxable year for which they reported a capital gain or capital loss as a result of the sale of their partnership interest. In these refund claims the [REDACTED] partners alleged that the settlement they entered into with Appeals (Form 870-P(AD)), concerning the loss claimed in the initial year of investment, caused them to report additional partnership income, which, in turn caused an increase to their basis in their partnership interest. The partners claimed a refund to the extent this basis

adjustment changed the amount of gain or loss originally reported. In a prior memorandum issued by this office we determined that this adjustment to basis was attributable to the Appeals settlement and was therefore permissible under I.R.C. § 6230(c)(1)(B), as long as the suit was timely filed in accordance with I.R.C. § 6230(c)(2)(B) and sufficient substantiation of the basis in the partnership was provided.

Recharacterization of loss:

In addition to the foregoing adjustment, certain [REDACTED] partners' refund claims, relating to the year their partnership interest was disposed of, also have recharacterized the nature of the loss claimed. These claim for refunds have stated that an abandonment of the partnership interest occurred entitling the partner to an ordinary loss under I.R.C. § 165. The initial reporting by these [REDACTED] partners of the disposition of their [REDACTED]-sponsored partnership interest was as a sale or exchange on Schedule K and capital loss treatment was claimed.

DISCUSSION

Abandonment Loss

Whether a taxpayer has met the necessary requirements to entitle him to an abandonment loss is a question of fact. Under I.R.C. § 165(a) a taxpayer may take a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. An abandonment loss is treated as an ordinary loss, unless it arises from the sale or exchange of a capital asset, in which case it is treated as a capital loss. Allen v. Commissioner, T.C. Memo. 1994-165. Abandonment losses are allowed if the requirements set forth at I.R.C. § 165 are met.

Section 165(a) permits taxpayers to claim a deduction "for any loss sustained during the taxable year and not compensated for by insurance or otherwise." For individuals, under section 165(c) losses on transactions are limited to those incurred in a trade or business or entered into for profit. Losses not incurred in transactions entered into for profit or in trade or business must arise from fire, storm, shipwreck, or other casualty or from theft.

I.R.C. § 165(c) limitations:

The [REDACTED]-sponsored partnerships were shams and without economic substance and thus fail to qualify as deductible losses under section 165¹. See [REDACTED]

[REDACTED] Note that the taxpayer has not claimed a theft loss but an abandonment loss so the non-profit motivated exceptions at I.R.C. § 165(c)(3) are not applicable.

Elements of abandonment:

The entire loss claimed should be disallowed under I.R.C. § 165(c), however, even if these limitations did not exist, an abandonment of a partnership interest may still not qualify for ordinary loss treatment. Section 165 generally provides that in order to be entitled to an abandonment loss, a taxpayer must demonstrate an intention on the part of the owner to abandon an asset as well as an affirmative act of abandonment. Citron v. Commissioner, 97 T.C. 200, 208-209 (1991). Generally, the abandonment of a partnership interest is not considered to be a sale or exchange and can be accorded ordinary (rather than capital) loss treatment. Rev. Rul. 93-80. An exception exists, however, where the taxpayer is relieved of liabilities as a result of the abandonment. In such instances, the decrease in the partner's share of liabilities can constitute a deemed distribution under section 752(b). In this circumstance the abandonment is treated as a sale or exchange of a partnership interest within the meaning of section 731(a), and results in capital gain or loss pursuant to I.R.C. 741.

Liabilities of "abandoning" partner

Any decrease in the abandoning partner's share of any partnership liabilities will preclude ordinary loss treatment.

¹ The determination of profit motive is a partnership item to be determined at the partnership level. Tallal v. Commissioner, 778 F.2d 275, 276 (5th Cir. 1985). I.R.C. § 7422(h) prohibits actions for refunds attributable to partnership items. The limited exceptions to this general rule set forth at I.R.C. § 6228(b) and 6230(c) are not applicable in this case.

O'Brien v. Commissioner, 77 T.C. 113 (1981), [pre-TEFRA] involved a partner's abandonment of his interest in a real estate partnership. The partnership held real estate subject to nonrecourse debt. The taxpayer sent a letter to the partnership abandoning his interest and walked away from the venture. The partnership continued in business. The Tax Court held that a partner's abandonment of his partnership interest resulted in a decrease in his share of the partnership liabilities within the meaning of section 752(b), not because he ever had personal liability under State law, but because he is no longer considered under the applicable Code provisions as sharing in the nonrecourse liabilities of the partnership. Ordinary loss treatment was not allowed. O'Brien v. Commissioner, 77 T.C. 113 (1981).

A partner's share of partnership liabilities is a partnership item. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(v). The question of whether there was a section 752(b) deemed distribution is a partnership item. Dakotah Hills Offices Ltd. Pshp. v. Commissioner, T.C. Memo. 1998-134; see also White v. Commissioner, 991 F.2d 657, 661 (10th Cir. 1993), aff'g T.C. Memo. 1991-552 ("reduction in partner's liabilities by reason of a partnership's assumption of those liabilities is a cash distribution" citing sec. 752(b)).

The question concerning the share of the abandoning partner's partnership liabilities and any decrease to this share of partnership liabilities may not be redetermined in this refund proceeding. As part of the facts needed to establish entitlement to the refund being claimed each partner must prove that, as a result of the so-called abandonment, there was no decrease in their share of the partnership liabilities. Such proof will consist of the books and records of the partnership. If the partnership tax return (Form 1065) for the year in question shows a deemed distribution going to the partner or if the partnership books and records show that at the time of the so-called abandonment this partner held a share of the partnership's liabilities, then no ordinary loss treatment should be allowed.

Other facts relating to abandonment:

In addition to resolving the question of any outstanding liabilities at the time of abandonment the partners must also establish that the facts and circumstances establish an abandonment occurred. O'Brien v. Commissioner, 77 T.C. 113 (1981); Stilwell v. Commissioner, 46 T.C. 247 (1966). Considering the passive nature of a limited partnership interest, the need to manifestly express the intent to abandon is

especially important. An affirmative act to abandon must be ascertained from all the facts and surrounding circumstances, United California Bank v. Commissioner, 41 T.C. 437, 451 (1964), affd. per curiam 340 F.2d 320 (9th Cir. 1965), and "the Tax Court [is] entitled to look beyond the taxpayer's formal characterization." Laport v. Commissioner, 671 F.2d 1028, 1032 (7th Cir. 1982). "The mere intention alone to abandon is not, nor is non-use alone, sufficient to accomplish abandonment." Beus v. Commissioner, 261 F.2d 176, 180 (9th Cir. 1958).

Abandonment vs. Sale/Exchange: Affected Item

The issue as to whether a sale or exchange occurred or an abandonment occurred is an affected item rather than a partnership item. An affected item is any item to the extent such item is affected by a partnership item. I.R.C. § 6231(a)(5). There are two types of affected items: (1) Computational affected items which follow from the result of a partnership level proceeding, and (2) affected items which may require factual development at the partner level. N.C.F. Energy Partners v. Commissioner, 89 T.C. 741, 744-745 (1987). In either instance, the affected items come into play after the underlying partnership item(s) is finally determined.

Section 6231(a)(3) provides that a "partnership item" means any item required to be taken into account for the partnership's taxable year to the extent prescribed by regulations as an item that "is more appropriately determined at the partnership level than at the partner level." See Dial USA, Inc. v. Commissioner, 95 T.C. 1 (1990) (laying out the limitations and effect of a unified proceeding).

The regulations under section 6231 do not provide that the character of the gain from the sale of a partner's interest in the partnership is an item more appropriately determined at the partnership level, nor does it appear to be an item that a partnership is required to take into account for its taxable year. See Treas. Reg. § 301.6231(a)(3)-1. In concluding that the character of a gain or loss under section 751 was an affected item the Tax Court stated:

We note that respondent apparently relies on section 751(a) in her determination of the character of such gain. In this regard, section 301.6231(a)(3)-1(a)(1)(vi), *Proced. & Admin. Regs.*, includes as partnership items:

Other amounts determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership or the partners to determine --

(E) the application of section 751(a) and (b).

Thus, partnership items include, inter alia, the elements necessary to determine whether section 751(a) or (b) applies, but not its consequences. Further, they do not include the character of the partnership interests in the hands of the individual partner, so as to determine the type of gain or loss, whether ordinary or capital, which occurs when the individual partner disposes of his interest. We therefore conclude that this issue does not involve a partnership item, and is not properly a part of the FPAA herein, so that we do not have jurisdiction in the premises.

Regents Park Partners v. Commissioner, T.C. Memo. 1992-336

For similar reasons the character of the loss at issue in these refund suits is also an affected item. While there will be elements of the determination as to whether a sale/exchange or an abandonment occurred that are partnership items (these include, the individual partner's share of the partnership liabilities and whether there was a section 752(b) distribution to the partner), and while the ultimate determination may turn on these partnership items, the consequences of these partnership items are not partnership items but affected items. Regents Park Partners v. Commissioner, T.C. Memo. 1992-336.

Timeliness of Refund Claim:

Under I.R.C. § 7422(h) a partner may not bring a refund suit attributable to partnership items unless authorized by I.R.C. §§ 6228(b) or 6230(c), refund suits attributable to affected items, however, are not prohibited. The timing of a refund suit attributable to an affected item is governed by I.R.C. § 6230(d)(1) and must be brought prior to the expiration of the statute of limitations under I.R.C. § 6229(a).

Proof of Abandonment:

As stated above, the question concerning the share of the abandoning partner's partnership liabilities and any decrease to this share of partnership liabilities may not be redetermined in this refund proceeding. Each partner claiming a refund must prove that, as a result of the so-called abandonment, there was no decrease in their share of the partnership liabilities. Such proof will consist of the books and records of the partnership. If the partnership tax return (Form 1065) for the year in question shows a deemed distribution going to the partner or if the partnership books and records show that at the time of the so-called abandonment this partner held a share of the partnership's liabilities, then no ordinary loss treatment should be allowed. In addition, the partner must show affirmative evidence of an intent to abandon the partnership interest.

CONCLUSION

The claimed loss should be disallowed under I.R.C. § 165 since the [REDACTED]-sponsored partnerships were economic shams. In addition, to the extent the partner's share of the partnership liabilities were decreased as a result of the alleged abandonment, ordinary gain/loss treatment is not allowed.

Please call Attorney Alice M. Harbutte at (303) 844-3258 if you have any questions.


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